Report No. D-2008-051 February 19, 2008

Inspector General

United States Department of Defense

Surface Deployment and Distribution Command Hawaii/Guam Shipping Agreement

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Acronyms

FAR	Federal Acquisition Regulation
IG	Inspector General
RDC	Regional Domestic Contract
SDDC	Military Surface Deployment and Distribution Command
USC	Universal Service Contract
USTRANSCOM	United States Transportation Command

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-4704

February 19, 2008

MEMORANDUM FOR COMMANDER, UNITED STATES TRANSPORTATION COMMAND

SUBJECT: Report on Surface Deployment and Distribution Command Hawaii/Guam Shipping Agreement (Report No. D-2008-051)

We are providing this report for review and comment. In preparing the final report, we considered comments on the draft report from the Commander, Military Surface Deployment and Distribution Command.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The Military Surface Deployment and Distribution Command comments were partially responsive. As a result of management comments, we revised our draft report recommendation and redirected the recommendation to the Commander, United States Transportation Command. Therefore, we request that the Commander, United States Transportation Command provide comments by March 20, 2008.

If possible, please send management comments in electronic format (Adobe Acrobat file only) to AudACM@dodig.mil. Copies of the management comments must contain the actual signature of the authorizing official. We cannot accept the / Signed / symbol in place of the actual signature. If you arrange to send classified comments electronically, they must be sent over the SECRET Internet Protocol Router Network (SIPRNET).

We appreciate the courtesies extended to the staff. Questions should be directed to Mr. Benjamin A. Mehlman at (703) 604-9291(DSN 664-9291) or Mrs. Susan J. Lippolis at (703) 604-9081 (DSN 664-9081). See Appendix F for the report distribution. The team members are listed inside the back cover.

By direction of the Deputy Inspector General for Auditing:

Richard B. Jolliffe
Assistant Inspector General
Acquisition and Contract Management

Department of Defense Office of Inspector General

Report No. D-2008-051 **February 19, 2008**
(Project No. D2006-D000AB-0236.001)

Surface Deployment and Distribution Command Hawaii/Guam Shipping Agreement

Executive Summary

Who Should Read This Report and Why? Personnel involved in procuring and managing commercial sealift services should read this report because it discusses issues involving the Surface Deployment and Distribution Command sealift procurement decision making process.

Background. We began this audit as a result of information obtained during our audit of "United States Transportation Command Compliance with DoD Policy on the Use of Commercial Sealift," (DoD Inspector General Report No. D-2007-105, June 21, 2007). Specifically, we obtained information at the Military Surface Deployment and Distribution Command (SDDC) that indicated DoD is not obtaining the most economic rates for shipments between the West Coast of the United States (West Coast) and the islands of Hawaii and Guam because those shipments are not procured through competitive procedures.

Historically, the United States Transportation Command and SDDC excluded shipments between the West Coast and Hawaii and Guam from Federal Acquisition Regulation (FAR) contracts due to congressional concerns that a head-to-head competition of a FAR contract might restrict the commercial carrier support to the islands and increase commercial rates, as a result of the decrease in DoD revenue. In the past, SDDC allowed the two main carriers serving Hawaii and Guam to file noncompetitive tariffs. The tariff rates were essentially the same for each carrier. The majority of SDDC shipments are covered under the Regional Domestic Contract or the Universal Service Contract, which are both FAR contracts. Shipments originating from the continental United States are covered under a Regional Distribution Contract and foreign shipments are covered under a Universal Service Contract.

As an alternative to utilizing commercial tariffs for shipments between the West Coast and Hawaii and Guam, SDDC developed the Surface Deployment and Distribution Command/Carrier Freight Ocean Traffic Uniform Agreement for Hawaii/Guam. This agreement went into effect on March 1, 2007, and provides carriers with standard guidance for moving cargo by vessel shipments between the West Coast and Hawaii and Guam. The agreement also locks in shipping rates for various types of cargo for a 60-day period and establishes performance standards. The objective of this new agreement was to obtain better shipping rates through competition.

Results. SDDC did not obtain competitive rates under the Hawaii/Guam shipping agreement and SDDC and participating carriers have not signed this agreement.

As a result, there is no assurance that DoD obtained fair and reasonable rates for shipments between the West Coast and Hawaii and Guam and that participating carriers are liable for poor performance. We identified an internal control weakness in that SDDC did not follow the FAR for obtaining full and open competition through the use of competitive procedures. The Commander, United States Transportation Command should direct SDDC, by October 1, 2008, to either:

- modify the Hawaii/Guam shipping agreement to discontinue the process of allowing carriers to view each others' rates by eliminating the two-cycle bid process, sign the agreement, and obtain all participating carrier signatures to the agreement or, alternatively

- add the Hawaii and Guam shipments to an existing FAR-based contract such as the Regional Distribution Contract or the Universal Service Contract. A FAR contract will improve internal control weaknesses in competition, ensure performance standards are enforceable, and eliminate the administrative burden associated with the current agreement.

Management Comments and Audit Response. The Commander, Military Surface Deployment and Distribution Command nonconcurred with the intent of the finding that SDDC did not obtain competitive rates and is not following FAR competitive procurement requirements for the Hawaii/Guam shipping agreement. The commander noted that there was no substantial evidence in the report for a conclusion that the Hawaii/Guam shipping agreement is not in the best interest of the Government. In addition, the commander stated that there was no basis for drawing a conclusion that the Hawaii/Guam shipping agreement did not contain competitive procedures. The commander concurred with the recommendation in principle but noted that SDDC past attempts to bring the Hawaii/Guam shipping routes under a FAR contract were stopped by congressional delegation concerns.

While the audit report does not state that the Hawaii/Guam shipping agreement was not in the best interest of the Government, it does note that SDDC did not obtain competitive rates under the agreement, nor have SDDC and the participation carriers signed the agreement. We continue to believe that placing shipments between the West Coast of the United States and islands of Hawaii and Guam under a FAR-based contract is the best solution to assure competition and fair and reasonable pricing. However, if the Hawaii/Guam shipping agreement was signed by the parties and binding, and included certain changes to discontinue the two-cycle bid process that allows carriers to view each others' rates, the agreement would greatly improve the opportunity to obtain competition through the use of competitive procedures and would assure that performance standards were enforceable and that carriers could be held accountable for poor performance.

As a result of the Commander, SDDC comments, we revised the draft report recommendation and redirected the recommendation to the Commander, United States Transportation Command. See the Finding section and Appendix E for a discussion of management comments. See the Management Comments section of the report for the complete text of the document. We request the Commander, United States Transportation Command comment on revised recommendations by March 20, 2008.

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Background

We began this audit as a result of information obtained during our audit of "United States Transportation Command Compliance with DoD Policy on the Use of Commercial Sealift," DoD Inspector General (IG) Report No. D-2007-105, issued June 21, 2007. Specifically, we obtained information at the Surface Deployment and Distribution Command (SDDC) that indicated DoD may not be obtaining the most economic rates for shipments between the West Coast of the United States (West Coast) and Hawaii and Guam because those shipments are not procured through competitive procedures.

The United States Transportation Command (USTRANSCOM) and SDDC excluded shipments between the West Coast and the islands of Hawaii and Guam from a Federal Acquisition Regulation (FAR) contract due to congressional concerns that competition between carriers under a FAR contract might put a carrier out of business, restrict commercial carrier support to the islands, and increase commercial rates. The majority of SDDC shipments are covered under the Regional Domestic Contract or the Universal Service Contract, which are both FAR contracts. The Regional Domestic Contract (RDC) covers all shipments between continental U.S. points and ports to Puerto Rico, the U.S. Virgin Islands, and Alaska. Foreign shipments are covered under a Universal Service Contract (USC).

Jones Act. Shipments between the West Coast and Hawaii and Guam are covered under the Jones Act, also known as the Merchant Marine Act of 1920. The Jones Act (section 55102, title 46, United States Code) requires the use of U.S. vessels to transport merchandise between U.S. ports. The Jones Act also requires these vessels be wholly owned by citizens of the U.S.

Congressional Interest. In the past, SDDC allowed the two main carriers serving Hawaii and Guam to file noncompetitive tariffs for DoD traffic. The tariff rates were essentially the same for each carrier. On May 18, 2006, personnel from USTRANSCOM and SDDC met with staff members from the Hawaiian congressional delegation. The purpose of this meeting was to discuss SDDC's plan to move from a tariff-based system to a competitive FAR contract for shipments between the West Coast and Hawaii and Guam. Subsequent to this meeting the Hawaiian congressional delegation forwarded a letter, dated June 7, 2006, to the Commander, USTRANSCOM, outlining its concerns regarding moving to a FAR contract, and requested additional information (see Appendix B). On July 7, 2006, the Commander, USTRANSCOM responded to Senator Daniel Inouye providing additional information and stating he was confident a FAR contract was appropriate to ensure adequate competition for rates, services, and standardized business processes, while benefiting both DoD and the people of Hawaii (see Appendix C). The same letter was sent to Senator Daniel Akaka and Congressman Neil Abercrombie. As of February 5, 2008, the Hawaiian delegation had not commented further on this issue.

Shipping Agreement. As an alternative to utilizing commercial tariffs for shipments between the West Coast and Hawaii and Guam, SDDC developed the

Surface Deployment and Distribution Command/Carrier Freight Ocean Traffic Uniform Agreement for Hawaii/Guam (Hawaii/Guam shipping agreement). This agreement went into effect on March 1, 2007, and provides carriers with standard guidance for moving cargo by vessel shipments between the West Coast and Hawaii and Guam. The agreement also locks in shipping rates for various types of cargo for a 60-day period and establishes performance standards. The objective of this new agreement was to obtain better shipping rates through competition and add performance objectives. The agreement was posted on the SDDC Web site and any Jones Act carrier interested in participating can submit bids.

USTRANSCOM Purpose and Structure. DoD Directive 5158.04, "United States Transportation Command," July 27, 2007, states that the Commander, USTRANSCOM has the authority to coordinate DoD transportation requirements. Officially, USTRANSCOM is responsible for creating and implementing deployment and distribution solutions during times of peace and war for DoD missions. USTRANSCOM is divided into three major component commands. The component commands include SDDC, the Military Sealift Command, and the Air Mobility Command. SDDC was the main focus of this audit.

SDDC provides commercial ocean liner service and traffic management services to deploy, sustain, and redeploy U.S. forces on a global basis. The command is also responsible for surface transportation and is the interface between DoD shippers and the commercial transportation carrier industry.

Objective

The objective of this audit was to determine whether SDDC's use of non-FAR methods for shipments between the West Coast and Hawaii and Guam was the most economical means to the Government in achieving fair and reasonable rates and service performance.

Review of Internal Controls

We identified internal control weaknesses for SDDC as defined by DoD Instruction 5010.40, "Managers Internal Control (MIC) Program Procedures," January 4, 2006. SDDC did not follow the FAR for obtaining full and open competition through the use of competitive procedures. Implementing recommendations contained in this report will correct the internal control weaknesses we identified.

Competition Under the Hawaii/Guam Shipping Agreement

SDDC did not obtain competitive rates under the Hawaii/Guam shipping agreement, nor have SDDC and the participating carriers signed the Hawaii/Guam shipping agreement. This occurred because SDDC is not following FAR competitive procurement requirements, and the SDDC and participating carriers could not agree on terms of the agreement. As a result, there is no assurance that performance standards under the agreement are enforceable and that DoD obtained fair and reasonable rates for shipments between the West Coast and Hawaii and Guam.

Criteria

The "Competition in Contracting Act of 1984," as implemented in FAR Part 6, "Competition Requirements," prescribes policies and procedures to promote full and open competition. FAR Subpart 6.101, "Policy," states that, in accordance with title 10, section 2304 and title 41, section 253 of the United States Code, contracting officers shall promote and provide for full and open competition in soliciting offers and awarding Government contracts. In addition, FAR Subpart 6.101 states that contracting officers shall provide for full and open competition through the use of competitive procedures such as sealed bids, competitive proposals, and other combinations of competitive procedures. FAR Part 15.402, "Pricing Policy," requires contracting officers to purchase supplies and services at fair and reasonable prices.

Rates Under the Hawaii/Guam Shipping Agreement

SDDC did not obtain competitive rates under the Hawaii/Guam shipping agreement, nor have SDDC and the participating carriers signed the agreement.

Establishing Rates. Under the agreement, rates are updated every 60 days. Within this 60-day period there are two bid cycles. Beginning in mid-November 2006, carriers obtained access to the Carrier Analysis and Rate Evaluation System[1] in order to input their rates for the first iteration of bids. Once the first iteration of bids is complete, the carriers are able to view rates that are accepted and either lower or match their price to the other carriers during the second iteration for their best and final offer. SDDC evaluates rates for fairness and reasonableness. Rates for container shipments found to be fair and reasonable went into effect on March 15, 2007.

[1] The Carrier Analysis and Rate Evaluation System allows carriers to submit bids and is used by SDDC to determine whether bids are fair and reasonable.

Carrier Rates Under the Agreement. We reviewed break-bulk[2] and container rates between the West Coast and Hawaii and Guam. Our review showed that although carriers submitted competitive rates under the first bid cycle, rates have, for the most part, remained the same, and in most cases, carriers just matched each others' rates. According to SDDC officials, carriers have not increased prices since the agreement was implemented, fearing other participating carriers would get the cargo based upon price. SDDC officials also stated that if carriers had to bid in a FAR environment without knowing what the other competitors' prices were, SDDC would most likely obtain lower prices because the carriers could not gauge competitors prices. Appendix D shows that, for the most part, carriers are just matching each others' rates under the agreement.

Determining Fair and Reasonable Prices. To determine whether prices received under the agreement were fair and reasonable, SDDC planning officials compared carriers' bids with independent Government cost estimates and with other carriers' offers. The carrier's rate is accepted if it is priced within a designated SDDC percentage of the lowest offer and the independent Government cost estimate. If the rate exceeds the independent Government cost estimate and the lowest offer by the designated SDDC percentage, the rate is considered high and the carrier is allowed to change its offer during the second bid cycle. The review under the second bid cycle is the same; however, carrier bids higher than the percentage margin of the lowest offer and the independent Government cost estimate are generally rejected. FAR Part 15 states this price analysis technique is preferred if adequate price competition formed the basis for previous prices. Because previously used tariff rates were not competitive, and the rates obtained under the agreement are not competitive, SDDC cannot be assured that the prices obtained under the agreement are fair and reasonable.

Signing the Agreement. At the time of our review, neither SDDC nor the carriers had signed the agreement. According to the Deputy to the Commander, SDDC, the carriers have not signed the agreement because they wanted the agreement to be in effect for a 10-year period and SDDC would not agree. SDDC planning officials stated that although the agreement has not been signed, all parties agreed to move forward with implementing the agreement.

Performance Standards Under the Agreement. Under the agreement SDDC has incorporated some of the same performance objectives that are incorporated in its USC and RDC contracts. Performance objectives include standards for meeting the required delivery date, submitting operational reports, and various reports that allow SDDC to track shipments. In addition, the agreement provides penalties for not meeting the required delivery date. However, because neither SDDC nor participating carriers have signed the agreement, it is unclear whether these performance standards are enforceable.

[2] Break-bulk cargo is any loose material that is not containerized.

Competitive Procurement Requirements

SDDC did not follow FAR competitive procurement requirements for shipments between the West Coast and Hawaii and Guam.

Federal Acquisition Regulation Requirements. FAR Part 6 prescribes policies and procedures to promote full and open competition in the acquisition process and to provide for full and open competition through the use of competitive procedures, such as sealed bids, competitive proposals, and other combinations that are designed to obtain better services and lower prices. None of these competitive procedures allow contractors to view each others' proposals or rates. Because carriers under the Hawaii/Guam shipping agreement are able to view and match each others' rates, these rates are not competitive and are therefore not in compliance with FAR Part 6. For example, one carrier waited until other carriers submitted their initial bids, and then matched these carriers when submitting its best and final offer in the second iteration. In addition, during the May bid cycle, this same carrier increased its rates to match the higher rates submitted by another carrier. Allowing the carriers to view and change rates between bid rounds negates any competitive benefit.

Adding Hawaii and Guam to RDC and USC Contracts. To determine the feasibility of incorporating the Hawaii/Guam shipping routes into the RDC and USC, we contacted the administrative contracting officers for these contracts. According to them, the Hawaii and Guam shipping lanes could easily be incorporated into these contracts. RDC and USC administrative contracting officers also stated incorporating these routes into the RDC and USC contracts would eliminate the administrative burden associated with the agreement.

Competition and Performance

SDDC cannot be assured that competitive rates are obtained under the agreement. In addition, because the agreement has not been signed, there is no assurance that performance standards are enforceable and that carriers can be held accountable for poor performance. Allowing carriers to view each others' rates and change their own rates before they are finalized negates the benefits of direct competition and reduces the likelihood that rates obtained under the agreement are fair and reasonable.

In addition, in August 2004, the Logistics Management Institute, under a contractual tasking from SDDC, examined strategic distribution business arrangements and performance within the Pacific area of operations to identify opportunities for improvement. The report found that the cost of service to Hawaii was high when compared with costs for movement to the Far East under SDDC contracts that are FAR-based. The report recommended that SDDC add the Hawaii route to the RDC contract, and the Guam route to the USC contract, concluding that this would benefit the Government by providing performance-based service under contractual terms and direct competition could yield less expensive service to DoD shippers. We believe that including the Hawaii and

Guam shipping routes under the existing USC and RDC contracts should result in less expensive service, ensure performance standards are enforceable, and eliminate the administrative burden associated with the current agreement.

Management Comments on the Finding and Audit Response

The Commander, SDDC did not concur with the finding statements that SDDC did not obtain competitive rates and is not following FAR competitive procurement requirements for the Hawaii/Guam shipping agreement. We disagree with the commander's statements and believe the finding factually presents SDDC actions regarding competitive rates and FAR competitive procurement requirements. See Appendix E for a summary of individual SDDC management comments and the Audit Response to those comments.

Recommendations, Management Comments, and Audit Response

Revised and Redirected Recommendation. As a result of management comments, we revised our draft report recommendation and redirected the recommendation to the Commander, USTRANSCOM.

We recommend the Commander, United States Transportation Command direct the Surface Deployment and Distribution Command by October 1, 2008, to either:

1. **Modify the Surface Deployment and Distribution Command/Carrier Freight Ocean Traffic Uniform Agreement to discontinue the process of allowing carriers to view each others' rates by eliminating the two-cycle bid process under the agreement. Sign the Surface Deployment and Distribution Command/Carrier Freight Ocean Traffic Uniform Agreement for Hawaii/Guam. In addition, obtain all participating carrier signatures to the Surface Deployment and Distribution Command/Freight Ocean Traffic Uniform Agreement for Hawaii/Guam, or,**

2. **Place shipments between the West Coast of the United States and the islands of Hawaii and Guam under a Federal Acquisition Regulation-based contract.**

Military Surface Deployment and Distribution Command Comments. The Commander, Military Surface Deployment and Distribution Command concurred in principle with a draft report recommendation that she add Hawaii and Guam shipments to the existing RDC and USC contracts but noted that past SDDC attempts to bring the Hawaii/Guam shipping routes under a FAR contract were stopped by Hawaii congressional delegation concerns. The commander also noted that acquisition authority for the RDC and USC contracts has been transferred to SDDC's parent command, USTRANSCOM.

Audit Response. As a result of the Commander, SDDC comments to the recommendation and to the report finding, we revised our draft report recommendation and redirected it to the Commander, USTRANSCOM. We continue to believe that placing shipments between the West Coast of the United States and the islands of Hawaii and Guam under a FAR-based contract is the best solution to assure competition and fair and reasonable pricing. However, if the Hawaii/Guam shipping agreement was signed by the parties and binding, and included certain changes to discontinue the two-cycle bid process of allowing carriers to view each others' rates, the agreement would greatly improve the opportunity to obtain full and open competition through the use of competitive procedures and would assure that performance standards were enforceable and carriers could be held accountable for poor performance. We request the Commander, USTRANSCOM provide comments on these recommendations by March 20, 2008.

Appendix A. Scope and Methodology

We conducted this performance audit from June through December 2007 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

We performed audit work to determine whether SDDC was obtaining competitive shipping rates between the West Coast and Hawaii and Guam. We collected, reviewed, and analyzed documents dated August 2004 through September 2007. Specifically we reviewed:

- the SDDC/Carrier Freight Ocean Traffic Uniform Agreement for Hawaii/Guam, March 2007;
- carrier rates dated March 15 through September 1, 2007;
- bid evaluation sheets for bid cycles one through four under the agreement;
- Hawaii/Guam Customer Advisory Notice, February 21, 2007; and
- congressional correspondence with USTRANSCOM on June 7, 2006, and July 7, 2006.

We also contacted the staffs of the Deputy Under Secretary of Defense for Logistics and Material Readiness, USTRANSCOM, and SDDC. We contacted those staffs, as applicable, to:

- evaluate rates submitted by carriers under the agreement,
- obtain feedback as to carrier performance and rates under the agreement,
- determine the rationale for not including the Hawaii/Guam shipping lane in existing FAR contracts,
- obtain feedback regarding the feasibility of including Hawaii and Guam in the RDC and USC contracts, and
- review performance standards under the agreement.

Because SDDC could not provide documentation to compare previous West Coast and Hawaii and Guam tariff shipping rates with rates under the agreement, we could not verify SDDC claims that rates have remained the same under the agreement. In addition, we did not evaluate the adequacy of competitive procedures for the RDC or USC because they were not the focus of this audit.

Use of Computer-Processed Data. We did not use computer-processed data to perform this audit.

Use of Technical Assistance. We did not require technical assistance to perform this audit.

Government Accountability Office High-Risk Area. The Government Accountability Office has identified several high-risk areas in DoD. This report provides coverage of the "DoD Contract Management" high-risk area.

Prior Coverage

During the last 5 years, the DoD IG has issued one report discussing United States Transportation Command use of commercial sealift. Unrestricted DoD IG reports can be accessed at http://www.dodig.mil/audit/reports.

DoD IG

DoD IG Report No. D-2007-105, "United States Transportation Command Compliance With DoD Policy on the Use of Commercial Sealift," June 21, 2007

Appendix B. Congressional Letter to United States Transportation Command

Congress of the United States
House of Representatives
Washington, DC 20515

June 7, 2006

General Norton A. Schwartz
Commander, United States Transportation Command
508 Scott Drive
Scott Air Force Base, Illinois 62225

Dear General Schwartz,

We write to request additional information regarding the Surface Deployment and Distribution Command's decision to move from a tariff-based system to a contract-based system for Department of Defense shipping to and from Hawaii and the mainland United States. We request this information because based on the information received to date, we have significant concerns that the potential negative impacts of this proposed change on consumers in Hawaii, businesses in Hawaii, and businesses engaged in ocean shipping have not been adequately examined. While these impacts may be manageable, we feel that they must be examined in more detail before we can support SDDC's proposal.

On May 18, 2006 several members of your command joined members of our staffs and representatives of the transportation companies engaged in ocean shipping between Hawaii and the mainland United States. We greatly appreciate your command's participation in this meeting and the information provided by your staff was useful, although somewhat incomplete.

Of special concern to us is that the meeting raised many questions about the motivation or need for the proposed change which the SDDC representatives present were unable to answer. In particular, beyond a vague discussion of SDDC's desire for "consistency" in its internal processes there were no other arguments given for the potential benefits to the government of moving from the current tariff-based system to a contract-based system. When asked if a problem with the quality of service provided by the shipping companies was a reason for the proposed change, our staff members present were told that service quality was not at issue. When asked if the prices charged under the current tariff-based system were not competitive market rates, our staff members present were told that the prices charged to the DOD were also not a reason for the proposed change.

In addition, during the meeting many potential impacts of the proposed change on Hawaii consumers and businesses were raised, but SDDC was not able to provide any analysis on the effects of this change on the market. First among these concerns is uncertainty about how the Department of Defense, as the largest shipping customer in the Hawaii-mainland United States shipping route, might impact the pricing structure of the entire shipping market by moving to a contract-based system. It seems obvious that the change proposed would have an impact on overall market rates in this shipping lane, but SDDC provided no information on this issue.

A second concern is how moving to a contract-based system may negatively impact the level of shipping service available in this shipping lane to both the DOD and private companies. Given

the military's need for flexibility and surge requirements, we feel that maintaining the current level of service provided in this shipping lane is of critical importance.

A final major concern raised was the impact of SDDC's proposed change on the health of the US merchant marine. The longevity of this industry is directly tied to coastwise trading routes and DOD's use of US-flagged and US-owned vessels. I'm sure you agree that any move that may erode the health of the US-flagged merchant fleet bears careful examination.

In order to form a more complete opinion of the potential impacts of the proposed SDDC change in shipping arrangements, we would like the following additional information:

- An analysis showing the potential savings to the US government of moving from the current tariff-based system to a contract-based system for Department of Defense cargo in the Hawaii-mainland US shipping lane.

- An analysis showing the potential impact on shipping rates for all types of cargo, both civilian and military, of moving from the current tariff-based system to a contract-based system for DOD cargo shipments.

- Any data demonstrating that the current tariff-rate system results in uncompetitive cargo shipment rates for all types of cargo currently moved by the DOD in the Hawaii-mainland US shipping lane.

- An analysis showing the potential impact of the proposed contract system on the level of shipping service provided in the Hawaii-mainland US shipping lane and shipping lanes between the islands of Hawaii.

- An analysis showing the potential impact on the size of the US-flagged merchant fleet of the proposed change from a tariff-based system to a contract-based system.

We look forward to working with you as this issue continues to develop in the future. We are confident that an arrangement can be reached that meets the needs of the Department of Defense, the people of Hawaii, and commercial stakeholders involved.

Sincerely,

Daniel K. Inouye	Daniel K. Akaka	Neil Abercrombie
US Senator	US Senator	Member of Congress

Appendix C. United States Transportation Command Response

UNITED STATES TRANSPORTATION COMMAND
508 SCOTT DRIVE
SCOTT AIR FORCE BASE, ILLINOIS 62225-5357

JUL 7 - 2006

The Honorable Daniel K. Inouye
United States Senate
722 Hart Senate Office Building
Washington DC 20510-1102

Dear Senator Inouye
Sir,

Thank you for your letter of 7 June 2006 regarding the Military Surface Deployment and Distribution Command's (SDDC) decision to move from a tariff-based system to a contract based system. In your letter you asked for information to form a better understanding of how SDDC's proposed changes would impact shipping services in your region.

First, concerning potential savings to the U.S. Government, there are several incentives for moving to a Federal Acquisition Regulation (FAR) based contract, to include ensuring fair and reasonable rates through market forces, bringing routes into standard SDDC global ocean transportation service business practices for full and open competition and improving service to the DOD through competition. Carriers' rates will be awarded through a FAR best value selection process. As tariff rates for Matson and Horizon are currently identical, the competitive FAR process will ensure carrier rates are developed independently and without foreknowledge of competitors' rates. In addition, contracts awarded under FAR meet the Competition in Contracting Act for full and open competition. Better service to DOD will be realized, as current tariffs do not include performance standards for carriers and in-transit visibility (ITV) reporting is voluntary and liability terms vary per carrier bill of lading.

You were also concerned with the potential impact on shipping rates for all types of cargo. Currently, Matson and Horizon DOD container tariffs are reviewed twice a year to allow for fuel surcharge changes and other adjustments. Most tariff adjustments with regard to Matson and Horizon typically reflect changes in their commercial tariffs. When there are differences between the tariffs, the lowest cost carrier rate is accepted and the other carrier normally matches this rate. DOD container tariff rates are basically equal and business is equitably distributed between the two carriers. DOD is a big volume preferred customer and SDDC expects that the carriers' DOD contract rates will be competitive with their commercial tariff rates. SDDC has no expectation that the DOD contract rates would form the basis for commercial shippers requiring comparable carrier negotiations/contracts, or have an adverse effect on commercial tariff rates.

Another issue of importance to you was whether any data was available that demonstrated uncompetitive cargo shipment rates under the tariff-rate system. Currently, tariffs for Matson and Horizon offer identical container rates and SDDC anticipates their contract rates will be comparable. However, substantial break-bulk costs savings have been obtained through competition since the new entrant, Pasha Hawaii Transportation Lines, began service.

Privately Owned Vehicle (POV) savings are estimated at $1.6M annually. Spot bid break-bulk measurement ton (MT) rates have been reduced from an average of $180 per MT to $53 per MT.

Additionally, you voiced concerns over potential impacts of the proposed contract system on the level of shipping service provided in the Hawaii-mainland U.S. shipping lanes and the shipping lanes between the islands of Hawaii. We anticipate no change in carrier service or DOD cargo volumes. SDDC will be contracting for commercially available liner service. Since contracts will have multiple awards, SDDC anticipates all carriers will be awarded traffic.

Finally, SDDC does not anticipate any impact on the size of the US-flagged merchant fleet due to the proposed change from a tariff-based system to a contract based system. Contract rates are expected to cover all carrier costs including depreciation and replacement of vessels. There is no anticipated change in cargo volumes seen for service to Hawaii. All carriers will participate in multiple award FAR-based contracts where contract minimums are based on price and service. Traffic will be booked to the appropriate carrier using best value criteria which considers required delivery dates, US Flag/Jones Act vessels, VISA preference, cost and past performance.

I am confident the FAR-based agreement is the right thing to ensure adequate competition for rates, services, and standardized business processes while benefiting both DOD and the people of Hawaii. As always, if I can be of further assistance please do not hesitate to contact me. Thank you again for your service and all you do for our country.

Sincerely

cc: OCJCS/LA
CDR, SDDC

NASchwartz

NORTON A. SCHWARTZ
General, USAF
Commander

Appendix D. Hawaii-Guam Agreement Break-Bulk and Container Rates

The following charts show the final accepted break-bulk and container rates for the first four bid cycles under the agreement. Break-bulk rates are per measurement ton with the exception of the vehicle and less-than-20-foot shipper container. These commodities are priced on a per unit basis. Container rates on the following page are also priced on a per unit basis.

Table 1. Break-Bulk Rates for U.S. West Coast to Hawaii Route

	March Rates			May Rates			July Rates			September Rates		
Commodity	**MATS**	**PSHI**	**HRZD**	**MATS**	**PSHI**	**HRZD**	**MATS**	**PSHI**	**HRZD**	**MATS**	**PSHI**	**HRZD**
General	$150	$150	$150	$150	$150	$150	$150	$150	$150	$150	$150	$150
Light vehicle	55	55	55	55	55	55	55	55	55	55	55	55
Vehicle	899	899	899	899	899	899	899	899	899	899	899	899
Heavy vehicle	75	75	75	75	75	75	75	75	75	75	75	75
Shipper container <20-feet	-	953	-	-	953	953	-	953	953	-	953	953

Table 2. Break-Bulk Rates for U.S. West Coast to Guam Route

	March Rates			May Rates			July Rates			September Rates		
Commodity	**MATS**	**CEGL**	**HRZD**	**MATS**	**CEGL**	**HRZD**	**MATS**	**CEGL**	**HRZD**	**MATS**	**CEGL**	**HRZD**
General	$ 281	$ 239	$ 189	$ 281	$239	$ 281	$ 281	$239	$ 281	$ 281	$239	$ 281
Light vehicle	169	193	143	169	193	169	169	193	169	169	193	169
Vehicle	1,460	-	1,460	1,460	-	1,460	1,460	-	1,460	1,460	-	1,460
Heavy vehicle	193	197	147	193	197	193	193	197	193	193	197	193
Shipper container <20-feet	-	-	-	-	-	1,100	-	-	-	-	-	-

Note: Acronyms defined at the end of the appendix

Table 3. Container Rates for U.S. West Coast to Hawaii Route								
	March Rates		May Rates		July Rates		September Rates	
Commodity	MATS	HRZD	MATS	HRZD	MATS	HRZD	MATS	HRZD
Dry Under 40 feet	$2,860	$2,860	$2,860	$2,860	$2,860	$2,860	$2,860	$2,860
Dry 40 feet and over	5,211	5,211	5,211	5,211	5,211	5,211	5,211	5,211
Dry High Cube 40 feet and over	5,659	5,659	5,659	5,659	5,659	5,659	5,659	5,659
Refrigerated Under 40 feet	4,143	-	4,143	-	4,143	-	4,143	-
Refrigerated 40 feet and over	5,176	5,176	5,176	5,176	5,176	5,176	5,176	5,176

Table 4. Container Rates for U.S. West Coast to Guam Route								
	March Rates		May Rates		July Rates		September Rates	
Commodity	MATS	HRZD	MATS	HRZD	MATS	HRZD	MATS	HRZD
Dry Under 40 feet	$3,249	$3,249	$3,249	$3,249	$3,249	$3,249	$3,249	$3,249
Dry 40 feet and over	4,571	4,571	4,571	4,571	4,571	4,571	4,571	4,571
Dry High Cube 40 feet and over	4,571	4,571	4,571	4,571	4,571	4,571	4,571	4,571
Refrigerated 40 feet and over	6,497	6,497	6,497	6,497	6,497	6,497	6,497	6,497

- Annotates that the carrier did not submit a rate or the rate was rejected.

Acronyms

CEGL	Central Gulf Lines, Inc.
HRZD	Horizon Lines, LLC
MATS	Matson Navigation Company
PSHI	Pasha Hawaii Transport Lines

Appendix E. Management Comments on the Finding and Audit Response

SDDC Comments on the Report Conclusion. The Commanding General, SDDC stated she did not find substantial evidence supporting the report's conclusion that the agreement was not in the best interest of the Government. Specifically she stated that although SDDC historically uses Federal Acquisition Regulation-based contracts, efforts to place the Hawaii/Guam shipping lanes under a FAR contract have been met with congressional and carrier opposition. She also stated that the decision to establish the agreement, rather than use a FAR contract was a collaborative decision made by SDDC, USTRANSCOM, the ocean carriers, and the congressional delegation.

Audit Response. While the audit report does not state that the Hawaii/Guam shipping agreement was not in the best interest of the Government, it does note that SDDC did not obtain competitive rates under the agreement, nor have SDDC and the participating carriers signed the agreement. As the agreement has not been signed by the SDDC, USTRANSCOM, or the carriers, there is no assurance that performance standards are enforceable and that carriers can be held accountable for poor performance. Thus, the commitment of the Government and the carriers to the collaborative decision noted by the SDDC Commander is questionable.

SDDC minutes from a May 18, 2006, meeting with SDDC officials, ocean carrier representatives, and staff from the offices of Senator Inouye, Senator Akaka, and Representative Abercrombie indicate that USTRANSCOM and SDDC officials fully supported moving Hawaii/Guam ocean services from tariffs to a FAR-based contract. SDDC officials noted in the meeting that the goal of the command is to "seek to create an environment that allows true competition." SDDC officials also noted that the current tariff system allows for "me too pricing, permitting one carrier to set a tariff rate, while allowing the other carriers to match the rate, which doesn't meet the definition of true competition" and that the carriers offer the same rates and rates are not locked in. Appendix D clearly demonstrates that rates under the agreement are not competitive, and that, for the most part, carriers are either matching each others' rates, or, in some cases, increasing their rates after viewing each others' rates during the first iterations of bids. Clearly SDDC's goal of seeking an environment that allows true competition is not being met under the agreement as presently implemented. In addition, while we did not state that the agreement was not in the Government's best interest, it is certainly questionable whether any agreement that allows one contractor to raise its price simply because another contractor's price is higher would be in the Government's best interest.

SDDC Comments on Competitive Procedures. The Commander SDDC stated the report does not support the conclusion that the agreement does not have competitive procedures. In addition, the Commander stated that carrier rates offered to the DoD must by law (section 2631, title 10, United States Code) be equal to or less than those charged to their commercial customers.

Audit Response. As shown in Appendix D, allowing carriers to view each others' rates during the first iteration of bids has resulted in carriers simply matching each others' rates. If the participating carriers were truly competing, we believe that they would not be matching each others' rates, in most cases dollar for dollar. Section 2631, title 10, United States Code states that carriers' rates may not be higher than rates for transporting like goods for private persons, not commercial customers. SDDC does not ensure that rates offered to DoD are equal to or less than those charged to commercial customers.

The SDDC Deputy Director for Business Processes stated that because commercial carriers' rates are structured differently, and that most large carriers receive volume discounts, such a comparison is not feasible.

SDDC Comments on Competitive Rates Under the Hawaii/Guam Shipping Agreement. The SDDC Commander stated that under the non-FAR agreement, 60-day rates are solicited competitively and independently from three carriers (Matson, Horizon, and Pasha) using the same automated system as the FAR contracting process. In addition, the commander stated that all carrier rates offered to the DoD must by law (section 2631, title 10, United States Code) be equal to or less than those charged to their commercial carriers.

Audit Response. SDDC could not demonstrate any tangible benefits resulting from implementing the non-FAR agreement. Although rates are obtained from the carriers every 60 days, allowing the carriers to view and match each others' rates does not provide for full and open competition as outlined in the FAR. In addition, SDDC does not perform an evaluation to determine whether carrier rates are equal to or less than those charged to their commercial carriers. At the time of our review, SDDC officials stated that such an evaluation is not feasible because commercial carriers' rates are structured differently and most large carriers receive volume discounts. As evident in Appendix D, rates under the Hawaii/Guam shipping agreement have not resulted in improved rates, and carriers are simply matching each others' rates.

SDDC Comments on FAR Competitive Procurement Requirements. The Commander, SDDC stated that FAR Part 47 allows an exception for transportation services purchase by transportation warrants, bills of lading, and similar transportation forms.

Audit Response. Although we agree FAR Part 47 allows transportation services to be purchased through the use of other contract vehicles, the SDDC process for obtaining these rates is not competitive. Again, we fail to see how competitive rates are being obtained when, after four rounds of bids under the agreement, carriers for the most part have matched each others' rates, dollar for dollar.

SDDC Comments on Performance Standards. The Commander SDDC stated that performance standards are monitored and enforced by the Carrier Services Branch, the same office that monitors the ocean FAR contracts.

Audit Response. As stated in the report, neither SDDC nor the participating carriers have signed the agreement. Therefore, the extent in which SDDC's Carrier Services Branch can enforce the penalties contained in the agreement for poor carrier performance is questionable.

SDDC Comments on Determining Fair and Reasonable Prices. The Commander SDDC disagreed with publishing the specific margin percentage used to determine fair and reasonable prices.

Audit Response. We agree SDDC's margin for determining fair and reasonable prices needs to be protected; therefore, we have removed all references to the specific margin percentage in the final report.

SDDC Comments on Competitive Procurement Requirements. The Commander, SDDC stated that although carriers are able to view their competitors' initial offers, their best and final offers are submitted in a closed bid system and that carriers can choose to lower or raise their rates. The commander also stated that allowing the carriers to view the initial bids was a compromise solution as carriers wanted the option of changing their rate daily similar to the tariff and tender process, and that it was accepted commercial transportation practice to know what their competitors are charging. In addition, the commander stated because the Hawaii traffic is not based on a long-term, locked-in contract, it allowed for periodic revision of rates; therefore, there was no competitive benefit in keeping rates secret.

Audit Response. We disagree that there is no competitive benefit to allowing carriers to view and revise their rates after viewing their competitors' rates. As noted in the draft report, carriers have, for the most part, matched each others' rates through four bid cycles. One carrier waited until the final iteration to submit a bid, and then exactly matched the other two carriers' bids. This reluctance by the carriers to participate in a closed bid system shows they are unwilling to compete based on price. We believe carriers will continue to match each others' rates if they are able to view their competitors' bids prior to final submission. According to the SDDC Deputy Director for Business Processes, the carriers have stated they do not want to compete with each other on price. The SDDC Deputy Director for Business Processes also stated that if carriers had to bid in a FAR-based environment without knowing each others' rates, SDDC would most likely get lower prices because the carriers would have no idea whether their price would win them cargo.

SDDC Comments on Competition and Performance. The SDDC Commander disagreed with the statement that including Hawaii/Guam shipping routes under the existing Universal Services Contract and Regional Domestic Contract should result in less expensive services. The commander stated under the current USC, Matson and Horizon submitted identical rates for Kwajalein traffic. In addition, the carriers' current Hawaii/Guam shipping agreement rates are lower than their USC FAR contract rates. If the Hawaii/Guam traffic is added to the current USC contract, the carriers likely will not offer international rates for this domestic service. International rates are kept relatively low because carriers cannot charge more than their international commercial rates, which is affected by foreign competition. There is no foreign competition in the domestic routes.

Audit Response. The USC and RDC contracts use FAR competitive procedures and do not allow participating carriers to view rates of other carriers prior to submitting their best and final offers. Under the Hawaii/Guam shipping agreement, carriers are allowed to view each others' rates after the initial bid and then lower or raise their bid accordingly. Having carriers compete through a sealed bid process should result in less expensive services. During our audit we

received various statements from SDDC personnel stating that rates were reduced when a new carrier entered the trade lane because carriers were unaware of other carriers' rates. In his July 7, 2007, response to the Hawaiian congressional delegation (Appendix C) the Commander, USTRANSCOM stated he was confident that a FAR-based agreement was the right thing to ensure adequate competition for rates, services, and standardized business processes while benefiting both DoD and the people of Hawaii. The Commander, SDDC also stated rates under the USC were higher than rates under the Hawaii/Guam shipping agreement. We expect that the rate charged for a container to travel from the West Coast to Kwajalein would be higher than a rate for a container traveling from the West Coast to Hawaii because the distance from the West Coast to Kwajalein is greater than the distance from the West Coast to Hawaii.

Appendix F. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition, Technology, and Logistics
Director, Acquisition Resources and Analysis
Director, Defense Procurement and Acquisition Policy
Deputy Under Secretary of Defense for Logistics and Material Readiness
Under Secretary of Defense (Comptroller)/Chief Financial Officer
Deputy Chief Financial Officer
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Director, Joint Staff

Department of the Army

Auditor General, Department of the Army

Department of the Navy

Naval Inspector General
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Department of the Air Force

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Commander, U.S. Northern Command
Commander, U.S. Southern Command
Commander, U.S. Joint Services Command
Inspector General, U.S. Joint Forces Command
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Commander, U.S. Central Command
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Commander, Surface Deployment and Distribution Command
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Other Defense Organizations

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Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Homeland Security and Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Committee on Armed Services
House Committee on Oversight and Government Reform
House Subcommittee on Government Management, Organization, and Procurement, Committee on Oversight and Government Reform
House Subcommittee on National Security and Foreign Affairs, Committee on Oversight and Government Reform

Surface Deployment and Distribution Command Comments

DEPARTMENT OF THE ARMY
MILITARY SURFACE DEPLOYMENT AND DISTRIBUTION COMMAND
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SCOTT AFB, IL 62225

SDDC-OPS-OC

JAN 0 8 2008

MEMORANDUM FOR PROGRAM DIRECTOR, ACQUISITION AND CONTRACT MANAGEMENT, INSPECTOR GENERAL, DEPARTMENT OF DEFENSE

SUBJECT: Report on Surface Deployment and Distribution Command Hawaii/Guam Shipping Agreement (Project No. D2006-D000AB-0236.0010)

1. SDDC does not find substantial evidence in the report for a conclusion that the Hawaii-Guam Agreement is not in the best interest of the Government. It is true that SDDC historically uses Federal Acquisition Regulation based contracts and has tried repeatedly to establish the Hawaii-Guam Agreement as a FAR contract. Due to the nature of the Hawaii-Guam shipping lanes, SDDC received significant Congressional and carrier opposition. A meeting between all interested parties, which included SDDC, U.S. Transportation Command, the ocean carriers and the congressional delegation, came to the collaborative decision to establish the current agreement instead of a FAR contract.

2. The report repeatedly states that the Agreement does not have competitive procedures, without giving any basis for this conclusion. All carrier rates offered to the DOD must by law (10 USC 2631) be equal to or less than those charged to their commercial customers. Carrier rates to high-volume international commercial customers, such as those in Korea, are relatively low due to competition from US and foreign carriers.

3. While the report does not clearly define its allegation that the Hawaii-Guam Agreement is not in the Government's best interest, it is a catalyst to revisit SDDC's desire for the Hawaii-Guam traffic to be under a FAR contract. All other SDDC repetitive ocean requirements worldwide are procured under a FAR contract.

4. Enclosed are SDDC's specific comments to the DODIG findings and recommendations. Questions should be directed to Ms. Patty Maloney at (757) 878-8147 (DSN 826-8147) or Ms. Pebble Price (757) 878-7431 (DSN 826-7431).

Encl

Kathleen M. Gainey

KATHLEEN M. GAINEY
Major General, USA
Commanding

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Final Report Reference

SDDC Comments on DODIG Report – Report on Surface Deployment and Distribution Command Hawaii/Guam Shipping Agreement (Project No. D2006-D00AB-0236.001)

SDDC nonconcurs with the following draft report findings and the recommendation. Comments on the findings and recommendation are as follows:

A. DODIG Finding: SDDC did not obtain competitive rates under the Hawaii/Guam shipping agreement.
SDDC comment: Under the non-FAR agreement, 60-day rates are solicited competitively and independently from three carriers (Matson, Horizon and Pasha) using the same system, CARE, as our FAR contract process. All carrier rates offered to the DOD must by law (10 USC 2631) be equal to or less than those charged to their commercial customers.

B. DODIG Finding: SDDC is not following FAR competitive procurement requirements.
SDDC comment: FAR Part 47 allows an exception for transportation services purchased by transportation warrants, bills of lading and similar transportation forms. SDDC uses non-FAR competitive procurement procedures when needed to support our ocean requirements as well as our domestic inland moves. To support ocean requirements, SDDC solicits non-FAR competitive rates through our One-Time-Only process as well as the Hawaii/Guam agreement.

C. DODIG Finding: There is no assurance that performance standards under the agreement are enforceable.
SDDC comment: The Hawaii/Guam Agreement performance standards are monitored and enforced by the Carrier Services Branch, the same office that monitors the ocean FAR-contracts.

Revised

D. DODIG Finding. Determining Fair and Reasonable Prices. When a carrier's rate is within a specifc percent of the lowest offer and the independent Government cost estimate, the rate is considered competitive and is accepted.
SDDC Comment: Strongly disagree with publishing in the DODIG report that SDDC allows a specifc margin between the lowest cost and an acceptable rate. SDDC's analysis and competitive range factors need to be protected as source selection sensitive information.

E. DODIG Finding. Competitive Procurement Requirements. Because carriers under the Hawaii/Guam agreement are able to view and match each others' rates, these rates are not competitive and are therefore not in compliance with FAR Part 6.
SDDC Comment: Carriers are allowed to view their competitors' initial offers. However, their best and final offers are submitted in a closed bid system. Carriers can choose to lower or raise their rates. Allowing the carriers to view the initial bids was a compromise solution as carriers wanted the option of changing their rates daily similar to the tariff and tender processes. It is accepted practice in commercial transportation for carriers to know what their competitors are charging. Because the Hawaii traffic is not based on a long term, locked-in contract, but to the contrary, allows for periodic revision of rates, there is no competitive benefit in keeping rates secret.

Final Report Reference

F. DODIG Finding. Competition and Performance. We believe that including the Hawaii and Guam shipping routes under the existing USC and RDC contracts should result in less expensive service.
SDDC Comment: Bringing the Hawaii and Guam shipping routes under a FAR contract will not necessarily lower the rates. Matson, Pasha and Horizon will be the same carriers participating in the FAR contract. Under the USC05 FAR contract, Matson and Horizon submitted rates for Kwajalein traffic and their current rates are identical. Also, their current Agreement rates are lower than their USC05 FAR contract rates for a 20-foot container: west coast to Hawaii $2,860 versus their west coast to Kwajalein of $3,907. If the Hawaii/Guam traffic is added to the USCO5 contract, the carriers likely will not offer international rates for this domestic service. International rates are kept relatively low because carriers cannot charge more than their international commercial rates, which is affected by foreign competition. There is no foreign competition in the domestic routes.

G. DODIG Recommendation: We recommend the Commander, Military Surface Deployment and Distribution Command add Hawaii shipments to the Regional Distribution Contract and Guam shipments to the Universal Service Contract. Revised and Redirected
SDDC Comment: Concur in principle. However, past SDDC attempts to bring the Hawaii and Guam shipping routes under a FAR contract were stopped by Congressional delegation concerns. Also, acquisition authority for these contracts has now transferred to USTRANSCOM.

Team Members

The Department of Defense Office of the Deputy Inspector General for Auditing, Acquisition and Contract Management prepared this report. Personnel of the Department of Defense Office of Inspector General who contributed to the report are listed below.

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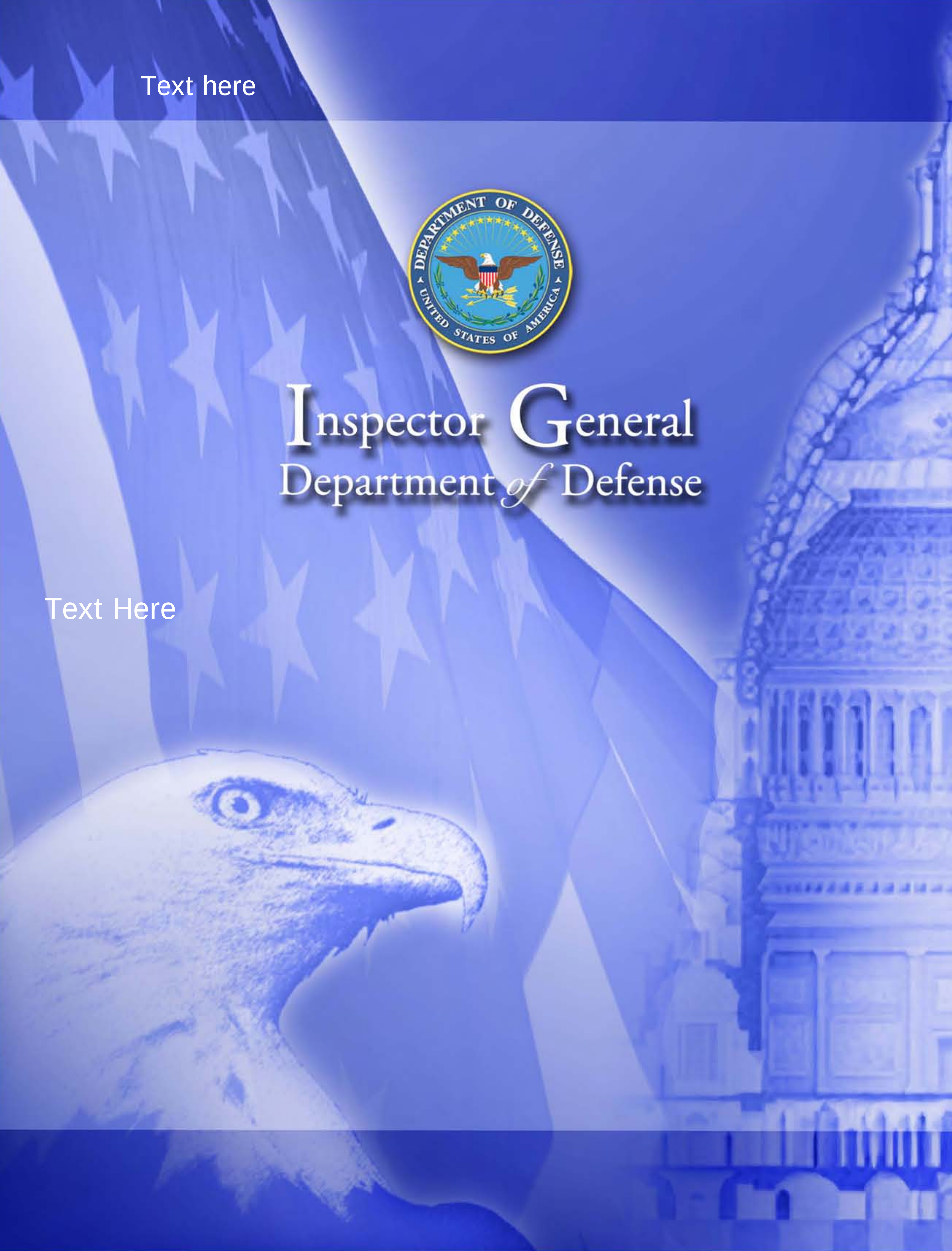
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